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Bankruptcy Outlook For 2011

By **Lance Duroni**

Law360, New York (January 1, 2011) -- The post-financial crisis bankruptcy boom began to lose steam at the end of 2010, but the coming year could present new opportunities for restructuring professionals in previously uncharted territory, including municipalities and the health care industry, according to experts.

In the first 11 months of 2010, 78,000 commercial bankruptcies were filed, according to the Bankruptcy Database Project at Harvard University, compared with the 82,000 filed over the same period in 2009.

The number of large bankruptcy filings has slowed considerably, with low interest rates allowing sizable corporations to refinance seemingly at will.

"Liquidity is flush through the market; many of the cases we expected to file have not occurred over the second half of 2010," said Rick Cieri, a senior partner at Kirkland & Ellis LLP. "This is as slow a period as I've seen in my career."

Smaller-to-midsize companies, which are dependent on bank financing, will not necessarily share in the easy-credit spoils that are propping up their larger brethren, however, according to Kitt Turner of Eckert Seamans Cherin & Mellot LLC.

"Midsize companies are not big enough to tap the public debt market and are up against the conservatism of their banks. At that point, it is just a question of how long the banks are willing to 'extend and pretend' — extend forbearance and maturity while pretending everything is OK," Turner said.

With an atmosphere of uncertainty clouding what could be the tail end of a restructuring boom, experts pointed to municipal bankruptcies, deficits in some European states, and health care and real estate in the U.S. as the key players in their bankruptcy forecast for 2011. Here are some things to look out for in the coming year:

Municipal Bankruptcy

When Cravath Swaine & Moore LLP agreed in November to a pro bono commitment to advise the city of Harrisburg, Pa., on its debt crisis, including a potential Chapter 9 bankruptcy filing, the firm could well have been getting a foot in the door of the first of municipal crises to come, experts said.

With the wave of home foreclosures taking a significant bite out of property tax revenue and worried consumers contributing less in the way of sales taxes, municipalities will likely have trouble meeting pension obligations and other guaranteed financial outlays, they said.

"The cash flow side of the balance sheet is now for the first time butting up against fixed costs," said Bill Kannel of Mintz Levin Cohn Ferris Glovsky & Popeo PC.

With tax increases a political nonstarter for most governmental entities, municipalities find themselves with an ever-narrowing set of options to pay down their debt.

Municipal bonds, which have historically low default rates, have always been a safe bet for investors, but recent trends indicate investors may be heeding the warning signs — the Nuveen Barclays Muni Bond Index has dropped more than 8 percent from a high on Aug. 31.

And municipal bankruptcy filings could shake investors' confidence in the bond markets further, Cieri said.

"Municipal filings will have a destabilizing effect on our financial markets, but it's hard to say how much restructuring work will result," he said.

Jay Goffman of Skadden Arps Slate Meagher & Flom LLP noted that BigLaw may not be the primary beneficiary of a Chapter 9 boom, either, with the work potentially falling into the laps of smaller bankruptcy firms.

"Politically, I think most municipalities will have a hard time hiring the major firms and major financial advisers because of the hourly rates — even though you get a better result and you can do it quicker, they'll just have a hard time justifying the expense to taxpayers," Goffman said.

Some restructuring professionals also pointed out that there was an institutional reluctance to entering Chapter 9 — along with the various legal hurdles — that could prevent the predicted torrent of municipal filings.

Only about half of the states in the U.S. permit municipalities to enter bankruptcy, and many prefer out-of-court solutions to avoid the stigma associated with Chapter 9, experts said.

"Having municipalities file for bankruptcy doesn't do a state's credit rating a lot of good," Kannel said.

Municipalities also can't pull the trigger on a bankruptcy filing as quickly as a private company, whose board can make the decision almost unilaterally.

"The number of decision-makers that you need to have involved in a municipal filing are a lot greater than simply what the board determines, working with the senior secured creditor, makes the most sense," Adam Rogoff of Kramer Levin Naftalis & Frankel LLP said.

P.I.G.S.

European states struggling with mounting deficits — the so-called P.I.G.S.: Portugal, Ireland, Greece and Spain — could be another destabilizing force on the bond markets that could lead to restructuring work in the U.S., experts said.

"If it turns out that European entities go through some sort of filing in their own respective countries, you'll likely see a companion Chapter 11 case coming into play," Rogoff said.

But he cautioned that a "fair degree of independence" between the U.S. and European operations of many multinational companies could mitigate against this outcome, unless the U.S. business obligated itself in a borrowing group for the European side or otherwise guaranteed its operations.

"They may be severable enough that they could have a European restructuring without the U.S. entity having to be dragged into its own Chapter 11," Rogoff said. "It really just depends on how interconnected they are."

Health Care

Health care is another area that could see a substantial uptick in bankruptcy filings in 2011, restructuring professionals said.

"We have seen over the last few years a dramatic increase in number of acute care hospitals and nursing homes have filed for bankruptcy. It's only gotten worse this year, and is reasonably anticipated to become even more of a source of filings in 2011 and 2012," Rogoff said.

He cited technological advances that were increasing the use of outpatient centers as one source of financial strain on traditional hospitals and nursing homes.

"Technology has increased to a stage where procedures that were previously done inpatient can now be done on an outpatient, ambulatory basis, and as a result a lot of competition is starting to mature," Rogoff said.

Community hospitals are also feeling the squeeze from private insurance companies and don't have the leverage to negotiate in an environment of rising health care costs and state Medicaid cuts, experts said.

Cieri was less bullish on the prospects for health care restructurings, however, citing the uncertain future of 2010's landmark health care legislation

"I don't think anybody can tell you where health care is headed until we have a better idea of what the federal spends are going to be," he said.

But Rogoff was skeptical about the solutions that health care reform could provide.

"You're still dealing with tremendous revenues that are required to come in to community hospitals from Medicaid, which is state-based," he said.

Many hospitals in the New York area are already operating at a loss, and it is doubtful that the federal government will be able to make up the budget shortfalls before tough decisions need to be made on a hospital-by-hospital basis, Rogoff said.

Hospitals may actually make their debt problems worse by eschewing a timely bankruptcy filing, according to Rogoff.

"In this regard it is akin to municipal filings," he said. "Unlike a private, for-profit company that might be more comfortable looking to a proactive Chapter 11 filing just to stabilize things, hospital boards, which come to being based upon a health care mission, have a real reluctance to look to Chapter 11 until all other avenues have been exhausted."

Commercial Real Estate

The rash of commercial real estate bankruptcies predicted for 2010, which did not really come to fruition, may begin to materialize in 2011, experts said.

The 2010 forecast was thrown off by the major banks' willingness to "extend and pretend" for fear that their balance sheets were not strong enough to take a write-down on the debt, according to Goffman.

"For whatever reason, either the banks got very scared or very serious, and decided it was not in their best interests to end up in bankruptcy court on those kinds of deals — it was better to do elaborate workouts," Mike Buckley of Reed Smith LLP said.

That debt is now starting to trade hands, experts said, which could be an ominous sign for commercial real estate companies that have remained solvent through the mercy of their lenders.

"I think the vacancies that exist for the commercial properties, as well as the increased costs that are out there for developing new properties that were in the process and that have been held up, are going to create more filing opportunities," Rogoff said.

With the economy sputtering back to life in fits and starts, 2011 presents an enigma for bankruptcy professionals, leaving some to wonder if the industry might have been afflicted with an irrational sense of optimism regarding future work levels.

"I think of the flood of bankruptcies predicted for 2010 and 2011 — retail chains going bankrupt, massive defaults by shopping centers — I see that as sort of the Y2K computer glitch played out in the bankruptcy arena," Buckley said.
